United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLANT

77-7146

United States Court of Appeals

FOR THE SECOND CIRCUIT

Docket No. 77-7146

B

P/S

DAVID GOLDBERG, suing derivatively in right and for the benefit of UNIVERSAL GAS & OIL COMPANY, INC.,

Plaintiff-Appellant,

—against—

YAACOV MERIDOR, MILA BRENER, DAVID MERIDOR, S. ERELL, GIDEON BEN AARON, ARA A. CAMBERE, H. STRUVE HENSEL, HAIM RAFAELI, MARTIN SIEM, JACOB SUTTON, HENRY A. SINGER, MARITIMECOR, S. A., MARITIME FRUIT CARRIERS COMPANY, LTD., HORNBLOWER & WEEKS, HEMPHILL NOYES, INC., LAVENTHOL & HORWATH a/k/a LAVENTHOL KREKSTEIN, HORWATH & HORWATH, DR. JACOBO DAMM, DR. MAX LEBEDKIN, ELIE HOUSMAN, H. L. FEDERMAN, WILLIAM J. FRIEDMAN, MERRIL M. HALPERN, PER HYSING-DAHL, ANDRE MONTELL, FRITZ KONIG, ZEV LEVIN, RAYMOND CALIEZI,

Defendants-Appellees,

—and—

UNIVERSAL GAS & OIL COMPANY, INC.,

Nominal Defendant.

UNITED STATES COURT OF APPEALS
FILED
APR 29 1977
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SECOND CIRCUIT

APPEAL FROM JUDGMENT OF UNITED STATES DISTRICT COURT DISMISSING PLAINTIFF'S AMENDED COMPLAINT

BRIEF OF PLAINTIFF-APPELLANT

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UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

DAVID GOLDBERG, suing derivatively in the right and for the benefit of UNIVERSAL GAS & OIL COMPANY, INC., Plaintiff-Appellant, -against- YAACOV MERIDOR, et al., Defendants-Appellees, -and- UNIVERSAL GAS & OIL COMPANY, INC., Nominal Defendant.	Docket No. 77-7146

BRIEF OF PLAINTIFF-APPELLANT GOLDBERG

PRELIMINARY STATEMENT

This is an appeal from a judgment dismissing the amended complaint pursuant to Fed.R. Civ. P. 12(b)(6) on the ground it fails to state a claim upon which relief can be granted. The Court below decided that the amended complaint did not allege the deceit or misrepresentation required for a Rule 10b-5 claim. 426 F. Supp. 1059 (S.D.N.Y. 1977) (Lasker J.) (A-107) */

*/ References are to pages in the Appendix.

The original and amended complaints each set forth one cause of action brought derivatively by Mr. Goldberg, a shareholder of Universal Gas & Oil Company, Inc. (UGO), against UGO's officers and directors and its two parent corporations, Maritimecor S.A. (Maritimecor) and Maritime Fruit Carriers Company, Inc. (Maritime Fruit) (A-6, A-42). In essence they allege that all defendants participated in a fraud to strip UGO of millions of dollars in cash for the benefit of Maritimecor, culminating in 1975 with an agreement to transfer 4.2 million shares of UGO's treasury stock for Maritimecor's assets and liabilities, and that Maritimecor's liabilities, including $7 million it owed to UGO, exceeded its assets.

With respect to the original complaint, defendants made a motion for an order requiring Mr. Goldberg to post security for costs and attorneys fees pursuant to New York Business Corporation Law, Section 627, on the ground the complaint included state law causes. The Court below agreed but alternatively permitted an amendment of the complaint to eliminate references to state law (A-35). The amended complaint was then served and filed setting forth basically the same facts without reference to state law (A-42).

Defendants then made the motion to dismiss pursuant to Fed. R. Civ. P. 12(b)(6), asserting that the amended complaint fails to state a federal claim for relief (A-56).

Answers to the original and amended complaints were never served. There has been no discovery by any party. A deposition schedule was set up, including depositions of defendants to be taken by co-defendant Siem, but all depositions were stayed by the Court below pending determination of the 12(b)(6) motion.

APPLICABLE STATUTES AND RULES

(1) Section 10 of the Securities Exchange Act of 1934, 15 U.S.C. Section 78j, provides in relevant part:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange-
>
> . . .
>
> "(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 10b-5, 17 CFR Section 240.10b-5, provides:

> "Employment of manipulative and deceptive devices.
>
> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> "(a) To employ any device, scheme, or artifice to defraud.

"(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

"(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security. "

QUESTIONS PRESENTED FOR REVIEW

1. Whether the amended complaint alleges deception, nondisclosure or manipulation.

2. Whether the amended complaint states a claim upon which relief can be granted.

3. Whether, on the facts of this case, deceiving or failing to disclose to minority shareholders supports the corporation's claim of a Rule 10b-5 violation.

4. Whether the Court below, given the facts in the record, should have permitted further amendment of the complaint.

STATEMENT OF THE CASE

The amended complaint asserts that defendants violated Rule 10b-5 and in essence states the following (A-42).

Mr. Goldberg sues derivatively on behalf of UGO. He has owned UGO stock since May 1972, when he purchased 164 shares of common through a public offering (A-44). The

individual defendants are directors and/or officers of UGO, of its parent corporations Maritimecor, and Maritime Fruit, and in some cases of any two of them (A-45,46). Maritimecor owns, 78% of UGO's shares. Maritimecor is wholly owned by Maritime Fruit (A-46).

The amended complaint alleges a scheme to defraud UGO starting with the raising of money through the May 1972 public offering. The UGO prospectus stated that the proceeds would be used to finance the construction and purchase of three vessels for transporting liquified gases and that UGO's business would be transporting liquified gas. Thereafter, in 1974, UGO sold contracts for two of these vessels for $25 million, realizing a $14 million profit. At the same time UGO was selling off these assets the cash proceeds were being used to finance its parent Maritimecor. Maritimecor borrowed a total of $7 million from UGO during 1974 and up to August 1975 (A-47,48).

The alleged fraud culminated in August 1975 when UGO entered into an agreement by which it was to issue 4.2 million of its shares to its parent Maritimecor for all of Maritimecor's assets, other than the 2.8 million UGO shares it already owned, plus all of Maritimecor's liabilities including the $7 million it owed to UGO (A-48,49). Maritimecor's assets and liabilities were transferred to UGO (A-48).

The amended complaint asserts this was a fraud on UGO because either Maritimecor's liabilities exceeded its

assets, or the net value of Maritimecor's assets was far less than the value of UGO's shares.

Defendants argued below that an allegation of deception or nondisclosure was required but not pleaded and that since this was a derivative action and all the directors and officers were charged with participation in the fraud it cannot be said that the corporation was deceived or lacked knowledge of all the facts. While Mr. Goldberg argued that in a derivative action deception of the corporation or its lack of knowledge were not relevant where all the directors and officers were charged with the fraud, nevertheless, an opposing affidavit on behalf of Mr. Goldberg showed that the only public information concerning the issuance of the 4.2 million shares for Maritimecor's assets and liabilities were two press releases, one in August, the other in December of 1975 (A-80,82). Neither release made any reference to (a) the amounts of Maritimecor's assets or liabilities, (b) the fact that the $7 million loaned to Maritimecor was in effect being forgiven, (c) the conflict of interest in that the other party to the transaction, Maritimecor, controlled the terms of the transaction and (d) the fact that Maritimecor as of the end of fiscal 1974 had current liabilities of $42.5 million and shareholders net equity of $40.4 million.

As a result of the fraud UGO, after paying Maritimecor's liabilities, is now insolvent and has defaulted on its own

obligations (A-102,103).

The lower Court analyzed the amended complaint and found that the allegations in the amended complaint "clearly constitute a valid state law claim" but "[C]onspicuously absent is any allegation of deceit, misrepresentation or falsehood with regard to the events which transpired (A-107 at 110-111). With this stated premise, the lower Court discussed whether or not deception or misrepresentation was required in a Rule 10b-5 case. Noting that the issue was not without difficulty, at least until the Supreme Court decided Santa Fe v. Green, ____U.S.____ 97 S. Ct. 54, 50 L. Ed. 2d 74 (1977), the lower Court held deception or misrepresentation was required and therefore dismissed the amended complaint.

POINT I

THE AMENDED COMPLAINT ALLEGES DECEPTION AND NONDISCLOSURE

We urge that the lower Court was incorrect in finding that the amended complaint did not plead deception or nondisclosure and in its statement that Mr. Goldberg "chose to frame the amended complaint in such a way as to exclude this element altogether." (A-118).

We submit that in the following paragraphs of the amended complaint, but separately and considered together, deception and nondisclosure are set forth (A-42).*/ Paragraph 6 of the amended complaint alleges Maritimecor's control over

*/ Either deception or nondisclosure will satisfy the requirements of Rule 10b-5. See for example, Santa Fe v. Green, supra.

UGO and the conflicts of interest resulting from the same officers and directors running all three corporations. Paragraph 16 states Maritimecor's liabilities exceeded its assets. Paragraph 19 states that the transactions referred to, particularly UGO's issuance of 4.2 million shares for Maritimecor's excess of liabilities over assets, was a fraud on UGO, and that untrue statements of material fact were made and material facts were ommitted. Paragraph 19 again states UGO and its independent minority shareholders were deceived. And paragraph 20 states that the truth of the transactions referred to were not disclosed.

With respect to deception and nondisclosure these allegations indicate that the public, including UGO's independent shareholders, was not told that the purported sale of UGO's stock, as well as the loans, was in reality a looting of UGO's cash to pay Maritimecor's liabilities, to UGO's financial damage. It means there was a failure to disclose to the independent shareholders the true purpose and circumstances of the transactions, particularly the value of the UGO stock and the fact that Maritimecor was to have the use of UGO's cash assets to pay its liabilities. We submit this pleads a violation of Rule 10b-5. See for example, Zeller v. Bogue Electric Manufacturing Corp., 476 F.2d 795 (2d Cir. 1973), cert. denied, 414 U.S. 908 (1973) (failure to disclose that loans were made for the purpose of the parent corporation); Schoenbaum v. Firstbrook, 405 F.2d 200, and at 215 (2d Cir. 1968) (en banc), cert. denied, 395 U.S. 906 (1969) (nondisclosure of valuable oil

properties which would have revealed the true value of the treasury stock); Cochran v. Channing Corp., 211 F. Supp. 239, 243 (S.D.N.Y. 1962) (failure to disclose the reason for the dividend cut).

It is submitted that the amended complaint properly pleads a cause of action within Rule 10b-5. This is particularly so where the amended complaint is measured against the liberality permitted in pleading even Rule 10b-5 causes. See for example, A. T. Brod v. Perlow, 375 F 2d 393 (2d Cir. 1967).

POINT II

A DERIVATIVE ACTION PURSUANT TO RULE 10b-5 MAY BE MAINTAINED EVEN THOUGH ALL DIRECTORS AND OFFICERS ARE ALLEGED TO HAVE PARTICIPATED

The argument was made below that because all directors and officers were charged with the fraud their knowledge is imputed to UGO. Therefore, it was argued, UGO knew all the facts and could not be deceived, and no action under Rule 10b-5 can be maintained on behalf of UGO.

This view was rejected in Pappas v. Moss, 393 F.2d 865 (3rd Cir. 1968), cited with approval in footnote 15 by the Supreme Court in Santa Fe v. Green, supra. As stated in Pappas v. Moss, supra, at p. 869:

> It is contended that proof of 'deception' is required to bring the claim within the statute and implementing Rule. Obviously the definition of 'deception' may vary

> with the circumstances. But if a 'deception' is required in the present context, it is fairly found by viewing this fraud as though the 'independent' stockholders were standing in the place of the defrauded corporate entity at the time the original resolution authorizing the stock sales was passed. Indeed, as the district court found, that resolution contained at least two material misrepresentations of fact. Certainly the deception of the independent stockholders is no less real because, 'formalistically,' the corporate entity was the victim of the fraud. The same is true of the fact that the fraud may go unredressed because those in a position to sue lack actual knowledge of the fraud.

The same view is expressed in Ruckle v. Roto American Corp., 339 F.2d 24 at 29 (2d Cir. 1964) ("courts have experienced no difficulty in rejecting such cliches as the directors constitute the corporation and a corporation, like any other person cannot defraud itself.") and Schoenbaum v. Firstbrook, supra.

Moreover, the fact that the directors and officers were not acting in UGO's interests and this was not an arms-length transaction, will itself constitute the deception at the suit of the corporation. The corporation and the independent shareholders were not getting the fully informed independent judgment in the decisional process which they had a right to anticipate and to which they were entitled. See Shell v. Hensley, 430 F.2d 819 (5th Cir. 1970) (cited with approval in footnote 15 in Santa Fe v. Green, supra), where a Rule 10b-5 case was upheld. The Court in Shell focused on the fact that the other party to the transaction controlled

the board of the corporation for which the action was brought. This was held to be sufficient to constitute deception because the board was disabled from making an informed decision. At p. 827 the Court stated:

> When the other party to the securities transaction controls the judgment of all the corporation's board members or conspires with them or the one controlling them to profit mutually at the expense of the corporation, the corporation is no less disabled from availing itself of an informed judgment than if the outsider had simply lied to the board. In both situations the determination of the corporation's choice of action in the transaction in question is not made as a reasonable man would make it if possessed of all the material information known to the other party to the transaction."

The Court upheld the Rule 10b-5 complaint because the corporation was alleged to have participated in a securities transaction in which it was prevented by both the other party and its own directors from taking advantage of the disclosure safeguards of the Rule. To the same effect see Bailey v. Meister Brau, Inc., 535 F.2d 982 at 993 (7th Cir. 1976) ("where the controlling stockholder caused the corporation to engage in a securities transaction in which the stockholder has a conflict of interest, it has the obligation to disclose to the other stockholders information in its possession which reflects on the fairness of the transaction.")

There is no real difference between the instant case and Superintendent of Insurance v. Bankers Life and Casualty Co., 404 U.S. 6 (1971) where on similar facts a Rule 10b-5 claim was upheld. In Bankers Life the scheme involved the sale

of Manhattan's Treasury bonds and the wrongful appropriation of the proceeds by the sole shareholder with the approval of certain independent directors who were lead to believe the proceeds were to go to Manhattan. In the instant case the scheme involved the looting of UGO's treasury through a purported "sale" of UGO's stock to its parent. The fact that all the directors of UGO participated in the transaction rather than the sole shareholder and some members of the board, is not a sufficent distinction to avoid the holding of Banker's Life. In fact, the instant case may be on all fours with Banker's Life. Defendant Siem claims he was deceived or not informed of the facts. In vigorously seeking the depositions of his co-directors, he claimed that as an outside director he had not known the facts about these transactions and the inside directors were refusing to tell him what had occurred. (Howrey & Simon motion for discovery dated December 23, 1976).

It is, therefore, submitted that alleging fraud against all the directors and officers of the corporation in a derivative suit does not preclude the applicability of Rule 10b-5. On the contrary deception and nondisclosure exist by virtue of Maritimecor's control over UGO's directors and officers and their consequent failure to exercise their judgment on behalf of UGO as expected and required by UGO and its minority shareholders, and their failure to inform the minority shareholders of the abdication of their responsibilities.

POINT III

BASED ON THE EVIDENCE BEFORE THE LOWER COURT A FURTHER AMENDMENT SHOULD HAVE BEEN PERMITTED

Given the allegations in the amended complaint, the statements and exhibits in the affidavits submitted on behalf of Mr. Goldberg, and the fact that no discovery was had, we submit that if the allegations of deception and nondisclosure were insufficiently pleaded, enough evidence was presented in the record to show a meritorious claim under Rule 10b-5 warranting repleading.

The cases recognize that evidence available to an independent shareholder in a derivative case is invariably minimal prior to discovery, and therefore judgment should rarely be granted dismissing the complaint. As stated in Schoenbaum v. Firstbrook, supra, at p. 218:

> This court has indicated that summary judgment should rarely be granted against a plaintiff in a stockholders derivative action especially when the plaintiff has not had an opportunity to resort to discovery procedures.

And in Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374 (2d Cir. 1974), cert denied, 421 U.S. 976 (1975), the Court recognized some relaxation in the pleading requirements because the complaining stockholders in a derivative suit have little information about the corporation's internal affairs and are rarely able to provide details as to the alleged fraud.

In the instant case the evidence in the record shows deceit and nondisclosure. The only public statements made about the transfer of 4.2 million UGO shares for Maritimecor's assets and liabilities were in press releases in August and December 1975 (A-80,82). They are deficient and misleading. They fail to state anything about the conflicts of interest of the principals. On the contrary, they imply that the directors' honest and independent judgment controlled their decision. Nothing is said about the forgiveness of the $7 million outstanding in loans by UGO to Maritimecor. And most importantly nothing is said in either release about the amounts of Maritimecor's assets and liabilities, and that Maritimecor's shareholders equity is over $2 million less than its current liabilities. The December 1975 press release changes the transaction slightly but does nothing to dispel the deception nor to disclose the true nature of the transaction. UGO was to give no more that 4.2 million shares in a formula to be based on the pro forma "adjusted net worth of UGO and Maritimecor at December 31, 1975", with "a ten percent premium to UGO's net worth (or at UGO's option, an alternative formula recommended by outside investment bankers)."*/ To say UGO had any option is untrue. UGO is controlled by Maritimecor, the other party to the transaction, and no one exercised unfettered judgment on its behalf. The so-called outside investment banker was not that at all. It was defendant

*/ The assets and liabilities were long ago transferred and UGO now is in default on its own obligations.

Hornblower & Weeks which acted on the board of UGO and Maritime Fruit through its partner defendant Cambere, who in turn was on the valuation committee established by UGO to evaluate the transaction. The general statements referring to appraisals and formulas omit any facts specifying what the appraisals show and what the formulas are, and the amounts involved.

The purpose of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 is to insure full and fair disclosure of all information surrounding the securities transaction. As stated in Santa Fe v. Green, supra, "...once full and fair disclosure has occurred, the fairness of the terms of the transaction is at most a tangenital concern of the statute." But the evidence in this record shows that a full and fair disclosure was never made.

We urge that the foregoing facts in the record amplify the amended complaint and establish its merit as a case within Rule 10b-5. Therefore, we submit it was error to dismiss and, at the very least, the lower Court should have granted leave to replead as requested. See for example, Voege v. Ackerman, 364 F. Supp. 72,73 (S.D.N.Y. 1973) (Weinfeld, J.)

> It is well established that a complaint should not be dismissed unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief.

See also, Madison Fund, Inc. v. Charter Co., 406 F. Supp. 749 (1975); South Suburban v. Safeway Lines, 256 F.2d 934 (2d Cir. 1958).

CONCLUSION

For all the foregoing reasons it is submitted that the lower Court's judgment should be reversed and the case remanded for further proceedings.

Respectfully submitted,

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United States Court of Appeals

FOR THE SECOND CIRCUIT

No. 77-7146

DAVID GOLDBERG,,
PLAINTIFF-APPELLANT

v.

UNIVERSAL GAS & OIL COMPANY, INC. et al
NOMINAL DEFENDANT

AFFIDAVIT OF SERVICE BY MAIL

Patricia D. O'Hara, being duly sworn, deposes and says, that deponent is not a party to the action, is over 18 years of age and resides at 51 West 70th Street, New York, New York 10023

That on the 29th day of April, 1977, deponent served the within Brief and Appendix upon SEE ATTACHED LIST

Attorney(s) for the SEE ATTACHED LIST in the action, the address designated by said attorney(s) for the purpose by depositing a true copy of same enclosed in a postpaid properly addressed wrapper, in a post office official depository under the exclusive care and custody of the United States Post Office department within the State of New York.

Patricia D. O'Hara

Sworn to before me,

This 29th day of April, 1977

Joseph E. Buselmeier

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